

TAX REVIEW COMMISSION

**MINUTES OF THE NINETH MEETING OF THE
TAX REVIEW COMMISSION
HELD AT 830 PUNCHBOWL STREET
DEPARTMENT OF LABOR & INDUSTRIAL RELATIONS ROOMS 310-313
IN THE CITY & COUNTY OF HONOLULU
STATE OF HAWAII, ON FRIDAY, MAY 18, 2012 AT 9:00 A.M.**

The members of the Tax Review Commission (TRC) met at the Department of Labor & Industrial Relations Conference Rooms, in the City and County of Honolulu, State of Hawaii, on Friday, May 18, 2012.

Members Present: Randall Y. Iwase, Chair
Mitchell A. Imanaka, Vice-Chair
Roy K. Amemiya, Jr.
Michael T. McEnerney
Darryl K. Nitta

Member Excused: Peter S. Ho

Staff: Donald Rousslang and Sondra Kaawa

Others: Randall Nishiyama, Department of the Attorney General
Hamid Jahanmir, Department of Taxation
Ted Shiraishi, Department of Taxation
Benjamin Brower, Department of Taxation
Lowell Kalapa, Tax Foundation
Anthony Valdez, WAM
Ken Takenaka, GCA
Peter Fritz

CALL TO ORDER

TRC Chair Iwase called the meeting to order at 9:00 a.m.

APPROVE MINUTES FROM PREVIOUS MEETING

Chair Iwase said Mr. McEnerney had something to say.

Mr. McEnerney noted that in the Public Financial Management (PFM) reports, they listed all of the TRC members as the people they interviewed whereas in his opinion, the TRC's discussion with the PFM did not constitute an interview. It was more of a discussion rather than an interview.

Chair Iwase asked Dr. Rousslang to ask PFM to correct their report. Chair Iwase agreed that it was a presentation by PFM to the TRC and not an interview. He understood that the others listed as interviewees were in fact interviewed by PFM.

Chair Iwase moved on to the approval of both the executive and regular minutes for the meeting on March 12, 2012. He asked if there were any changes, comments or requests for amendments to the minutes of March 12, 2012.

Mr. Amemiya noted that under agenda item "Approved Minutes from Previous Meeting", the word "asked" should be inserted in the first line after Chair Iwase.

Chair Iwase asked for a motion to approve the minutes for the March 12, 2012 meeting. The motion was made by Mr. Imanaka and seconded by Mr. Amemiya.

Chair Iwase asked for a motion to approve the minutes for the March 12, 2012 meeting. The motion was made by Mr. Imanaka and seconded by Mr. Amemiya. The motion carried unanimously.

COMMUNICATION TO THE COMMISSION

None

LEGISLATIVE REPORT

Chair Iwase gave a brief review of what transpired at this past legislative session. There were two companion bills to extend the life of the TRC for one year. The House bill, referred to the Economic Revitalization and Business Committee, Representative Angus McKelvey, Chair, and Representative Isaac Choy, Vice-chair, was never heard. The Senate bill, referred to the Ways and Means Committee, was heard and sent over to the House, but the Senate bill was not heard by the House.

In mid April, 2012, both bills to extend the TRC were dead because the House had not acted on those bills. It required some creative efforts on the part of those who believed the TRC should be extended to find ways to resurrect the content of the bill. The Senate put the content of the TRC extension into a House bill, and the bill was sent to the House. The House finally decided to hold a conference meeting on the bill. The bill passed the Conference Committee and both houses of the legislature.

Therefore, the TRC has been extended until 2013. Chair Iwase wanted to acknowledge help from Senator David Ige, Chair, Ways and Means Committee, and Senator Carol Fukunaga, Chair, Economic Development and Technology Committee. He said that without their efforts, the TRC would not be meeting today because under the law the TRC would have expired. He also wanted to recognize the efforts of Representatives Marcus Oshiro, Marilyn Lee, and Ryan Yamane, who were extremely supportive of the TRC. Chair Iwase also wanted to thank Dr. Donald Rousslang, Ms. Titin Sakata and Director Fred Pablo for attending the Conference Committee meetings. He also thanked Mr. Nitta who attended one of the Conference Committee meetings that Chair Iwase was unable to attend. With the team work and help from the Governor's Office, the TRC is extended one year.

The TRC's request for an additional \$100,000 was not granted. The money was not available. The TRC will have to live within the budget of \$200,000.

PROGRESS REPORT – CONSULTANT STUDIES

Chair Iwase said the progress report on the consultants' studies will be given by Dr. Rousslang.

Dr. Rousslang gave an update on the status of the studies and other work requested by the TRC as follows:

The Study by the PFM Group:

Dr. Rousslang said that the PFM Group's progress reports (made on March 26, 2012 and on April 30, 2012) were emailed to the Commissioners.

Dr. Rousslang recapped that the PFM Group is to provide the following:

- (1) A study on tax adequacy for the 21st century.*
- (2) Alternate tax structures that could improve Hawaii's ability to generate sufficient revenues.*

The scheduled due dates for their report are August 31, 2012 for a draft report and September 28, 2012 for their final report. They have indicated they may want to speed up the submission dates for their reports.

In March, the PFM Group made detailed data requests to gather revenue and expenditure data needed for their models. Members of the Group met with appropriate agencies in Hawaii, including the Administrators of the Employer-Union Health Benefit Trust Fund and the Employees' Retirement System, to gain a solid notion of the structure of our State budget and the important challenges it faces.

The PFM Group completed the basic "shell" of their budget model and entered data on demographic trends and revenue forecasts. There was a delay in meeting their request for detailed data on expenditures from the Department of Budget and Finance and the Department of

Accounting and General Services. The data were recently secured and sent to them (May 14, 2012), but they have some follow-up questions about the data.

By their last report, the PFM Group was looking for good benchmarks (comparisons with other state or local economies) to design the appropriate baseline and to identify key drivers to apply their financial models to Hawaii and continue to research the tax structure and tax policy issues. They hope to start applying their model in June.

Chair Iwase asked if there were any questions for Dr. Rousslang regarding the PFM's update.

Mr. Amemiya said that Dr. Rousslang mentioned a delay in getting the expenditure report to PFM and PFM noted in their report that it may push the deadline back. Mr. Amemiya asked if PFM's concern that they might not meet the deadlines was that still the case.

Dr. Rousslang said that PFM got the data on May 14th and was not sure but believed they expect to be able to meet the deadlines established in the contract. It also depended on resolving some of the issues PFM has with the data. If unsolvable, it might prevent them from meeting the contract deadlines.

The Studies by Dr. William Fox

Dr. Rousslang recapped that Dr. Fox is to provide the following:

- (1) An update of the study "Hawaii's General Excise Tax: Should the Base Be Changed?"*
- (2) An update of the study "Implications of the Streamlined Sales Tax Agreement for General Excise Tax Revenues"*

In addition to material in the original study under (1), Dr. Fox has agreed to estimate how much we would need to raise the GET if we used it and the Public Service Company Tax to replace the corporate and individual net income taxes.

In addition to the material in the original study under (2), Dr. Fox has agreed to provide a narrative that describes measures other states have taken to combat the loss of revenue from E-commerce. He also promised to include losses from other remote sales besides internet sales in his estimates. A draft of the study is due June 18, 2012 and the final report is due July 18, 2012.

Dr. Fox started work on the study in early May, as was his original promise. He is a very capable and reliable researcher with a proven track record who is tasked with providing a very predictable product.

Chair Iwase questioned if Dr. Fox was also going to provide the TRC with information on what other states maybe doing to capture revenue lost from ecommerce.

Dr. Rousslang said yes, that Dr. Fox had agreed to provide a narrative that describes measures that other states have taken.

Chair Iwase asked if there were any questions to Dr. Rousslang regarding the Dr. Fox update.

Chair Iwase asked Dr. Rousslang if Dr. Fox had any idea of what maybe transpiring with the three federal bills before Congress trying to address the Quill case, which the Supreme Court said that Congress has to do.

The Studies and Information Requested from the Department of Taxation

Chair Iwase said there were four reports that the Department of Taxation (Department) will be providing the TRC.

Dr. Rousslang recapped that the Department has promised to provide the following materials.

(1) An update of Appendix A of the report of the 2005-2007 TRC (Study on the Question "Is Hawaii's Tax Structure Adequate?")

(2) An update of Appendix I of the report of the 2005-2007 TRC ("Summary of Recommendations Made by Tax Review Commissions," which describes what has happened in response to recommendations of previous Commissions).

(3) Tabulations showing what the revenue cost would be from eliminating the Hawaii State income tax on those below the poverty level under various options (such as eliminating the refundable food excise tax credit).

(4) Background for the TRC to make recommendations on what the Department of Taxation needs to facilitate collections.

For (1), a draft study has been produced and distributed to the Commission. It will be updated and, if feasible, its results will be compared with those of the PFM Group.

For (2), background work has been done. A draft has been completed that updates Appendix I to the actions of the 2011 Legislature. The Appendix will be further updated to incorporate the actions of the 2012 Legislature.

For (3), tabulations have been produced. A narrative of the methods and results will be prepared.

For (4), a letter was sent by the Director of Taxation to Chair Iwase describing collection of taxes and enforcement of tax laws. The Department awaits further requests for information from the Commission.

Mr. McEnerney said he had a couple of questions. First, on page one of Director's letter, he interpreted the statement that if "accounts that are in bankruptcy or pending write-offs" were not considered as money that could be collected, that would leave \$485.2 million in the second group of figures.

The second page of the letter mentioned \$18.4 million less revenue than the previous year as the apparent result of a reduction in staff in the Department. He concluded that by not spending or having trained staff to collect revenue, we were losing significantly more revenue than that group could be costing the State. In other words, the employees did not cost \$18 million, but not having them, the State potentially lost \$18 million.

Mr. McEnerney stated that there was no way we can reduce the amount of uncollected taxes under the system we have today and that the gap was growing faster than we were able to reduce it.

Dr. Rousslang said historically that would be the case, the net balance has grown, but he is not an expert on this topic and would have to get back to the TRC on this.

Mr. McEnerney said he felt it was an easy cost analysis that we could say we are being foolish by cutting the Department's staff when there was revenue out there.

Dr. Rousslang said he wanted to make one point that it is two different things when talking about the cost of collections and the amount collected. A dollar collected is a dollar more for the State and a dollar less for someone in the private sector, whereas, the cost to hire someone to collect taxes is a net cost for society.

Mr. McEnerney said that it is a philosophical issue. He disagreed with the first statement that for every dollar the government collects a dollar that is not spent by the private sector. He did not think that that a dollar in someone's pocket that is not going to the government is going to be spent in Hawaii for Hawaii's benefit. In addition, there is a question of fairness in the tax system in Hawaii. If we have \$1.3 billion worth of uncollected taxes, why should one pay taxes?

Chair Iwase asked Dr. Rousslang to elaborate on his explanation.

Dr. Rousslang said the amount you collect is not a net social gain, whereas the cost is a net social cost.

Chair Iwase asked "Net gain to what?"

Dr. Rousslang said to society. It's a transfer from one part of society to another, from the private sector to the government.

Chair Iwase said isn't that what taxation is.

Dr. Rousslang said yes, but the net welfare gained from that transfer is not equal to the amount of the transfer.

Chair Iwase said he thought what Mr. McEnerney said and what they were all concerned about is an obligation to pay. He said it was obvious that there was about \$500 million unpaid taxes. He asked how we could get that \$500 million. He said that as long as it was not paid, the loss was to all of us, as a society.

Dr. Rousslang said he was just quoting standard economic cost benefit analysis. In other words, if it costs \$500 million to collect \$500 million, there would be a big net loss to society.

Mr. McEnerney said this has to do with the underlying issue of fairness which is one of the original principles that the TRC is dealing with. He said if one uses Dr. Rousslang's analysis, one would argue it is not worth pursuing anyone who owes taxes who has not voluntarily paid their taxes. He argued that since we have a voluntary system, to make it fair, we must enforce it. He added that cutting the budget of the people that are trying to enforce the system would lead to more tax evasion because of lack of enforcement.

Mr. Imanaka said he thought they were talking apples and oranges, the economic versus policy theories. He thought that from the Department's stand point, it was probably a compliance issue. He could see what Mr. McEnerney's point was.

Chair Iwase said on a follow up to Director Pablo's letter, he believed that the natural thing to do is to hire more people. He asked for other suggestions that the Department might have other than increasing the number of people. He asked if the Department is looking at structural ways to capture or prevent this issue upfront.

Mr. Nitta said for example, a couple of year's ago, the Department came up with an amnesty program. He asked if it was successful, and if the Department would consider doing that again. He said the Director's letter referred a report dated September 30, 2011. He asked if there are similar data going back five years. He was interested in looking at a trend.

Dr. Rousslang said he is sure there are some historical data.

Mr. Nitta said for every dollar that came out of the audit litigation system, it seemed that sixty cents on the dollar were collected, whereas forty percent was in bankruptcy or written off. He would like to see historical data to see if that trend holds true that for every dollar that comes out of the audit process.

Dr. Rousslang said according to his understanding, it very hard to determine what is actually collected from audit assessments from the Department's data.

Mr. Amemiya said he was confused as to suspension for audit litigation, what is that and why is it not actively being worked on?

Mr. Nitta said he thought it was actually the amounts actively being worked on. Those are the amounts a taxpayer is disputing with the Department and those are the amounts assigned to an audit staff that is in charge of the account.

Mr. McEnerney said he believed what is happening is that there are two branches, audit and collections. He explained that the top that has not moved out of the audit side because it is with the Board of Tax Appeals. He added that it does not mean it is not being worked on; it is still on the audit side like the IRS does.

Mr. Amemiya said the reason he brought that up is because he used to serve on the Tax Appeals Board. In the past, the back log was incredible and there was a lot of money tied up. He added the focus should not only on the collection side, but also on getting the back log cleared out.

Mr. Nitta said these are just the things that we know about. He asked if there any way to estimate or come up with the "unknown" account receivable.

Dr. Rousslang said they did some very rudimentary things on the tax gap in Hawaii, but as mentioned by Mr. Nitta, nobody knows.

Mr. McEnerney said the staff in collections branch did not waste time on \$10. Therefore, without going back to paper (manual), we would not know who owed under \$2,000, \$2,000 - \$5,000, \$5,000 - \$10,000, and more than \$10,000, for example.

Mr. Fritz said if you go back to 2008 law that changed the statute of limitations, there was a discussion about collections and aging of accounts. The statute of limitation was fifteen years not ten years (like the federal government has). There was a discussion about aging the accounts receivable. There are statistics in the testimony from the federal government that says the odds of collecting the money are reduced after about three years. Therefore, if the TRC was reviewing the \$500 million, they needed to look at the ages of the accounts receivable.

Mr. Nitta said he believed sixty percent could be collected.

Chair Iwase stated the TRC is not simply focusing on collections. He said he understood that Director Pablo is looking at information technology; however, the TRC would appreciate more details or information on the plan.

Mr. Nitta said he did not want to waste Dr. Rousslang's time by asking him to go back and review all paper files to compile data. He suggested that the Department set up a system so that there is an ability to produce an automated report rather than manually analyzing each accounts.

Dr. Rousslang asked if the TRC is suggesting changes to the Department's computer system.

Mr. Nitta said yes, that the Department would need to determine the key features the computer system would need in order to justify spending the money and resources to switch to something new.

Mr. McEnerney clarified that the TRC is not asking Dr. Rousslang to look at files, that they are asking what is the process to find such information and if it is to look through paper files, then they would recommend it to be computer based.

Mr. Nitta asked if the Department could break down the account receivables in the past five years into various tax types. Mr. Nitta reminded that the Department presented a pie chart on tax revenues, that about 60% is from GET, 30% is from corporate and personal income, and 10% is from small tax types.

Mr. McEnerney suggested that the TRC invites a representative from Collections Branch, a senior collector, to the next meeting to have a discussion about the collections process.

Mr. Nitta volunteered to work with Dr. Rousslang in coming out with a report on collections for the TRC to review.

Chair Iwase requested that a representative from Collections Branch, a senior collector, attend the next meeting to discuss issues they are facing in their work.

NEXT MEETING

Chair Iwase set the next meeting on Thursday, June 21, 2012 at 9:00 a.m.

ADJOURNMENT

The meeting was adjourned at 9:47 a.m.